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## Testimony

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Credit, and Rural Development,  
House Committee on Agriculture

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# FARMERS HOME ADMINISTRATION

## Farm Loan Programs and Proposed Changes

Statement of John W. Harman, Director,  
Food and Agriculture Issues,  
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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the Farmers Home Administration's (FmHA) farm loan programs and, as you requested, to offer our views on H.R. 4906--the proposed Agricultural Credit Improvement Act of 1992. The bill, among other things, proposes the establishment of a program to aid beginning farmers and the revision of certain FmHA loan-processing procedures. Our testimony is based primarily on our recently issued report,<sup>1</sup> which examined FmHA's direct and guaranteed farm loan programs and the agency's management of farm inventory properties from the perspective of their vulnerability to fraud, waste, abuse, and mismanagement.

In summary, we concluded in our report that the federal investment in farm loans is not adequately protected and that FmHA has not been effective in improving the financial condition of borrowers so that they can obtain commercial credit, as was originally intended. Specifically:

- FmHA has forgiven billions of dollars in delinquent farm loans in recent years, but its portfolio continues to be financially stressed. For example, we estimated that about 70 percent of FmHA's outstanding direct loan debt (\$19.5 billion as of September 1990) is held by delinquent borrowers or by borrowers whose debts were rescheduled in response to past repayment difficulties.
- FmHA's problems stem from (1) ineffective implementation of loan-making, loan-servicing, and property management standards by the agency's field lending officials and (2) loan and property management policies, some congressionally directed, that are in conflict with fiscal controls designed to minimize risk and financial losses. Ironically, some of these policies and practices, which were intended to assist farmers, have instead made some FmHA borrowers financially weaker by, among other things, allowing them to accumulate large amounts of debt.
- FmHA's role and mission need to be clarified, or the agency's problems will continue. No clear guidelines enable FmHA to balance its responsibilities as the "lender of last resort" for the nation's farmers with its responsibilities as a fiscally prudent lender.

In regard to H.R. 4906, we agree with the underlying intent of the bill, which partially addresses problems discussed in our recent report. In particular, we agree with the proposal to provide closely supervised, conditional credit to new farmers as a

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<sup>1</sup>Farmers Home Administration: Billions of Dollars in Farm Loans Are at Risk (GAO/RCED-92-86, Apr. 3, 1992).

means of increasing their chances for long-term success. We also support efforts to target assistance to new farmers and to establish maximum lengths of time for making that assistance available to them. These efforts are consistent with our belief that FmHA's role and mission need better definition. However, we note that H.R. 4906 does not set limits on the length of time that FmHA is expected to provide financial help to borrowers who are not new farmers. Resolving this issue, as well as other related ones, would, in our view, be important toward further clarifying FmHA's fundamental role and mission. Furthermore, we agree with the intent of the provisions in H.R. 4906 that are aimed at having loan decisions made on a timely basis.

In the remainder of my statement, I will discuss the results of our review of FmHA's farm loan programs and our views on H.R. 4906 in more detail. Let me begin by providing a brief background.

#### BACKGROUND

FmHA, an agency of the U.S. Department of Agriculture, provides credit to farmers who are unable to obtain funds elsewhere at reasonable rates and terms. The agency provides credit assistance through direct loans, which are funded by the government, and through guaranteed loans, which are made by commercial lenders to farmers and guaranteed up to 90 percent by the government. FmHA's assistance is intended to be temporary; once farmers have become financially viable, they are to "graduate" to commercial sources of credit. When borrowers do not repay their loans, FmHA can acquire the properties that were pledged as security for the loans and subsequently sell the properties.

The review of FmHA's farm loan programs that led to our April 1992 report was part of a special audit program implemented in 1990 to respond to congressional and our concerns about the continued existence of serious breakdowns in internal control and financial management systems throughout the government. This program focuses on areas that we believe are highly vulnerable to waste, abuse, and mismanagement. It is a long-term effort that will evolve over time as agencies correct their problems and as we identify new areas of concern. Continued efforts to identify and correct deficiencies in these high-risk areas and other federal programs should significantly reduce losses of federal funds due to waste, abuse, and mismanagement and increase the economy and efficiency of federal programs.

#### BILLIONS OF DOLLARS IN FARM LOANS ARE AT RISK

Our April 1992 report disclosed that the multibillion-dollar federal investment in farmer loan programs is not being adequately protected. The following discussion summarizes some of the problems we found with direct loans, guaranteed loans, and farm inventory properties.

## Problems With FmHA's Direct Loans

In the April 1992 report, we estimated that almost \$14 billion, or as much as 70 percent of FmHA's direct loan portfolio (\$19.5 billion outstanding as of September 30, 1990), is at risk because it is held by delinquent borrowers or by borrowers whose debts have been rescheduled in response to past repayment difficulties. This level of risk exists even though FmHA forgave about \$4.5 billion in direct loan debt in fiscal years 1989 and 1990.

Ineffective implementation of FmHA's loan-making and loan-servicing standards has contributed to FmHA's direct loan problems. For example, agency officials have approved loans that were not based on realistic estimates of production, income, and expenses, and they have not verified borrowers' debts as required. FmHA reviews of direct loans made from fiscal years 1988 through 1991 disclosed that 13.5 percent of the sampled loans did not demonstrate the borrowers' repayment ability. In fiscal year 1991, 18 percent of the sampled loans in 15 states did not show that borrowers' debts had been verified. In addition, FmHA lending officials have not, as required, annually inspected property offered as loan collateral and have not annually analyzed the operations of borrowers experiencing financial difficulty.

Lenient loan-making policies, some congressionally directed, have further increased the government's exposure to direct loan losses. For example, from fiscal year 1988 through the first 8 months of fiscal year 1991, FmHA lent \$67 million to delinquent borrowers. Furthermore, during fiscal years 1989 and 1990, FmHA lent \$38 million to over 700 borrowers who had not repaid previous loans that had resulted in losses totaling \$108 million. Almost half of these borrowers became delinquent again on their FmHA loans.

Loan-servicing policies have resulted in losses for the government without making farmers financially viable and able to graduate to commercial credit. Debt rescheduling and debt reamortization--options that extend the repayment period for farm operating and ownership loans--typically capitalize unpaid interest and add it to the outstanding loan principal without increasing the loan security. Such actions can result in excessive debt and loss of equity for borrowers and in undersecured loans for the government. Furthermore, congressionally directed debt write-downs and debt write-offs--options that reduce or forgive debts that are 180 days or more overdue--provide incentives for farmers to default on their loans and result in substantial losses for the government. Overall, FmHA's efforts to strengthen borrowers' financial positions through restructuring their loans have not succeeded. As a 1990 GAO report disclosed, over 90 percent of the borrowers reviewed were financially weak, with high debt-to-asset ratios

and/or low cash flow margins, after their debts were restructured.<sup>2</sup> According to FmHA, about 43 percent of all borrowers whose debts were restructured from November 1988 to March 1990 became delinquent again.

#### Problems With FmHA's Guaranteed Loans

In recent years, FmHA has shifted its loan-making emphasis from direct to guaranteed loans. In our April 1992 report, we disclosed that, like the direct loan portfolio, the guaranteed loan portfolio suffers from problem debt. FmHA estimated potential losses of \$1.2 billion, or about 28 percent of its guaranteed loan portfolio (\$4.1 billion outstanding as of September 30, 1990). This level of risk exists even though FmHA paid commercial lenders about \$300 million to cover loan losses during the past few years. In February 1992, FmHA told us that its guaranteed loan loss projections are unrealistically high and that it plans to change its loss projection formula. We agree with FmHA's assessment that its guaranteed loan loss projections appear high. However, we remain concerned that the federal government's investment in this program is at risk because the program has experienced many of the same problems as the direct loan program and has the budget authority to grow significantly in the near future.

In the guaranteed, as in the direct, loan program, FmHA officials often do not meet loan-making and loan-servicing standards. For example, FmHA reviews from fiscal years 1988 through 1991 showed that 13.4 percent of the sampled guaranteed loans did not meet a key FmHA standard covering repayment ability. Furthermore, USDA Office of Inspector General and our reviews in recent years have shown that county officials are not adequately overseeing commercial lenders to ensure that they are carrying out their loan-servicing responsibilities.

FmHA's guaranteed loan policies also contribute to the government's exposure to financial loss. For example, because FmHA allows commercial lenders to refinance existing debt and routinely guarantees most loans at the maximum 90 percent, private lenders have shifted their high-risk debt to the government. In fiscal year 1988, about \$550 million, or about 44 percent of the guaranteed loan funds, was used to refinance existing debt. In addition, because FmHA allows borrowers who have defaulted on past direct loans that resulted in losses to receive new guaranteed loans, 137 borrowers received about \$15 million in guaranteed loans in fiscal years 1989 and 1990 after having previously received about \$26 million in debt relief.

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<sup>2</sup>Farmers Home Administration: Changes Needed in Loan Servicing Under the Agricultural Credit Act (GAO/RCED-90-169, Aug. 2, 1990).

### Problems With FmHA's Farm Inventory Properties

FmHA estimated that, as of September 30, 1991, it had about 3,100 farms in inventory that were acquired from borrowers who did not repay their loans. Legislation requiring FmHA to sell acquired properties at fixed prices to targeted purchasers--often the previous owners--has limited FmHA's return on these properties and increased its holding costs. Also, targeting may not achieve legislative objectives and may, in fact, result in abuse by purchasers. Finally, weaknesses in FmHA's oversight of inventoried properties have at times resulted in the unauthorized use of the properties.

### Conflicting Roles Cloud FmHA's Mission

In the April 1992 report, we stated our belief that by almost any measure, FmHA's loan programs have become good examples of how programs should not be implemented and managed. Because legislation has not established clear priorities for FmHA's mission, the agency has tried simultaneously to meet conflicting objectives--to be fiscally prudent and to provide high-risk borrowers with temporary credit to keep them in farming until they secure commercial credit. Arguably, FmHA has not achieved either objective. Its shaky loan portfolio does not reflect the operations of a prudent lender. Furthermore, as an assistance agency, FmHA has had little success in graduating borrowers to commercial sources of credit, as was originally anticipated. Ironically, some of FmHA's clients are financially weaker after FmHA's help than before.

### Recommendations and Matters for Congressional Consideration Included in Our Report

Our April 1992 report contained numerous recommendations to the Congress and to the Secretary of Agriculture that are aimed at (1) improving compliance with loan and property management standards and (2) strengthening policies and program design in the direct loan, guaranteed loan, and farm inventory property areas (app. I contains these recommendations). The report included language that the Congress may wish to use in implementing the legislative recommendations. In the report, we also expressed our belief that the Congress needs to clarify FmHA's role and mission. Until it does, continued deterioration in FmHA's farm loan portfolio and further losses are likely. We believe that, in clarifying FmHA's role, the Congress should establish some broad parameters for FmHA's operations and should specify

- acceptable ranges of losses for FmHA's direct and guaranteed loan programs;
- limits for the length of time that borrowers may receive FmHA financial assistance;

- the type and extent of assistance, if any, that should be made available to help unsuccessful borrowers obtain other employment;
- the extent that loan funds can be used by customers already holding loans made or guaranteed by FmHA and by new customers, such as beginning farmers; and
- the extent that loan funds can be used to refinance existing debts and new credit purchases.

#### H.R. 4906 WOULD ESTABLISH NEW PROGRAMS AND REVISE PROCEDURES

H.R. 4906--the proposed Agricultural Credit Improvement Act of 1992--contains provisions to, among other things, (1) establish programs to aid new farmers and ranchers and (2) revise certain aspects of FmHA's loan-processing operations.

#### New Farmer Provisions

Among other things, the bill proposes the establishment of a farm operating loan program in which (1) loan funds would be targeted to individuals with 5 or fewer years' farming experience, (2) assistance would be available for up to 10 years, and (3) annual funding would be based on an approved plan of operations and an analysis of actual operations. This program's aim is to put new farmers in a financially viable position, independent of the need for further FmHA assistance, within 10 years. A second provision of H.R. 4906 provides for down payment loans, as a part of FmHA's farm ownership loan program, in which funds would be targeted for use by individuals with 5 to 10 years' experience in operating a farm or ranch. This program's aim is to further enhance the financial viability of new farmers by putting them in a position to build equity in their farming operations. Under H.R. 4906, the percentages of FmHA's total farm program loan authority targeted for new farmer operating and ownership loans would increase over the next several years to 50 and 80 percent, respectively.

Although not fully addressing our concerns about FmHA's farm loan programs, these provisions are consistent with our belief that FmHA's role and mission need better definition. In particular, the bill targets loans to new farmers and limits the time for which assistance is to be available. As we noted earlier, however, the Congress could take other actions to further clarify FmHA's role, such as establishing limits on the time that loan assistance would be available for borrowers who were not new farmers.

#### FmHA Loan-Processing Provisions

H.R. 4906 contains various provisions concerning FmHA's operating procedures. One provision provides a time frame for

field offices to follow in processing farm operating loan applications and a reporting requirement for applications whose processing has not been completed according to that schedule. A second provision, which is also apparently aimed at improving timeliness, would establish a time frame in which loan applications are to be considered by the county committees that determine applicants' eligibility to participate in FmHA's loan programs. We agree with the goal of expediting loan decisions that underlies these provisions.

A third provision of H.R. 4906 requires that guaranteed loan borrowers have sufficient income to meet (1) debt service expenses (principal and interest); (2) other obligations and expenses, including capital replacement; and (3) living expenses. Currently, through regulation, FmHA requires a borrower's anticipated income to equal or exceed cash outflow--debt service, operating, and living expenses--plus a reserve of at least 10 percent above debt service expenses. The 10-percent reserve is to allow for new investments and the uncertainties associated with the farming operation. It appears that H.R. 4906 could be interpreted to require that FmHA replace its 10-percent reserve requirement with a capital replacement contingency requirement. Although we believe that there should be some reserve requirement, it is difficult to comment on the possible impact of this particular provision until it has been interpreted in implementing regulations.

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Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions that you or Members of the Subcommittee may have.



RECOMMENDATIONS IN GAO/RCED-92-86, APRIL 3, 1992

To improve compliance with loan and property management standards and to strengthen policies and program design in the direct loan, guaranteed loan, and farm inventory property areas, our April 1992 report made the following recommendations to the Congress and to the Secretary of Agriculture.

RECOMMENDATIONS TO THE CONGRESS

A. Concerning direct and/or guaranteed loans, we recommended the following amendments to the Consolidated Farm and Rural Development Act, as amended (P.L. 87-128, Aug. 8, 1961):

- To strengthen FmHA's direct loan-making policies, (1) prohibit direct loans to previously delinquent borrowers whose direct loans were bought out with debt write-off or restructured with debt write-down and (2) eliminate direct loans to delinquent borrowers.
- To strengthen FmHA's direct loan-servicing policies and to limit the amount of debt that can be accumulated through rescheduling and reamortizing loans, (1) limit a borrower whose debt is 180 days or more overdue to one restructuring action and (2) require that a borrower repay the interest portion of the loan payment as a condition of rescheduling or reamortizing loans that are less than 180 days delinquent.
- To protect the government from excessive losses on FmHA's guaranteed loans, require FmHA to establish and implement a range of guarantees that places the highest percentage guarantee on the least risky loan and a lower percentage guarantee on the most risky loan.
- To strengthen FmHA's loan-making standards, prohibit loan guarantees for borrowers (1) whose defaulting on previous guaranteed loans resulted in FmHA's paying commercial lenders' loan loss claims or (2) whose direct loans were bought out with debt write-off or restructured with debt write-down.

B. Concerning farm inventory property, we recommended the following amendments to the Consolidated Farm and Rural Development Act, as amended:

- To improve the quality of FmHA's properties that are used for program purposes, change the definition of suitable

property to reflect only properties that FmHA considers to be viable, independent farming units for the locale.

- To increase FmHA's returns from sales of suitable farm inventory properties and reduce the amount of time that properties remain in inventory, require that FmHA use competitive methods in selling such properties to targeted purchasers.

#### RECOMMENDATIONS TO THE SECRETARY OF AGRICULTURE

A. Concerning direct and/or guaranteed loans, we recommended that the Secretary require the FmHA Administrator to take the following actions:

- To increase compliance with existing standards for making and servicing both (1) direct loans and (2) guaranteed loans, develop and implement a system that will ensure that lending officials adhere to FmHA's loan-making and loan-servicing standards.
- To avoid making new loans that will add to the current high level of problem debt and to better ensure that any new loans that FmHA guarantees do not add to the current high level of risk exposure, as an interim step towards improved compliance, require that all (1) direct loan applications and (2) guaranteed loan applications--or, if resources do not permit, a randomly selected sample of such applications--be reviewed by state offices before final approval.
- To strengthen FmHA's lending policies, develop more comprehensive loan-making criteria for (1) direct loans and (2) guaranteed loans that assess an applicant's financial solvency, profitability, liquidity, and repayment ability before a new loan is made or a loan guarantee is approved.
- To strengthen FmHA's direct loan-servicing policies, (1) develop a method for calculating the average holding period that reflects normal property market conditions in servicing delinquent borrowers' debts and (2) require security for serviced loans that at least equals the loan's outstanding principal or that provides the best security interest available on all of the borrower's assets.

B. Concerning farm inventory property, we recommended that the Secretary require the FmHA Administrator to take the following actions:

APPENDIX I

APPENDIX I

- To improve management control over FmHA's farm inventory properties, centralize property management functions at the FmHA state office level.
- To provide accurate information for property management, place high priority on completing corrections to FmHA's Acquired Property Tracking System and conducting full testing to ensure that these efforts have been successful.

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